CALIFORNIA STATE TEACHERS' RETIREMENT BOARD

INVESTMENT COMMITTEE

SUBJECT: Report on Actively Managed Equity — ITEM NUMBER: 9

ATTACHMENT(S): 2

ACTION: ___ — DATE OF MEETING: March 8, 2000

INFORMATION: X — PRESENTER(S): Ms. Okada

SUMMARY

During 1997 and 1998 the Investment Committee reviewed the role of active management in the CalSTRS equity portfolio for both the domestic and non-U.S. allocations. Discussions included the continuation of active management and the appropriate targets and ranges for the allocations. The committee approved the following:

- Continuation of active management with a target of 20% of the domestic equity allocation with a range of 15% to 25%.
- Continuation of active management with a target of 50% of the non-U.S. equity allocation with a range of 45% to 55%.
- Issuance of Requests for Proposals for both mandates.

Staff began implementing these plans in 1998. An objective for the current fiscal year is to report on the progress of these plans. Attachment 1 addresses the implemented structure for the domestic equity segment of the portfolio. Attachment 2 evaluates the progress to date for the non-U.S. equity segment.

Conclusions

The following attachments contain historical and current portfolio and return information. An analysis of calendar year 1999 shows that active management in both the domestic and non-U.S. portfolios have provided diversification and added value over the appropriate benchmarks.

DOMESTIC EQUITY

From 1986 through 1994 there was a relatively consistent 80/20 split between passive and active management in the domestic equity portfolio. In early 1994 the passive/active allocation was modified to allow the assets of active managers that were terminated to flow into the passive portfolio. By 1997 the allocation to active management had declined to 10%. The active component lacked diversification with this altered strategy. As the active manager roster began to deplete and assets were removed from different sectors of the market, CalSTRS' exposure to market capitalization and value/growth styles was altered. This resulted in an unintentional bet within the active component, which was to smaller capitalization stocks, thereby increasing its volatility to the broad market.

To address this issue an analysis of the role of active management in CalSTRS' domestic equity portfolio was presented to the Investment Committee by Pension Consulting Alliance (PCA) in August 1997. Discussion issues included: 1) the role of domestic equity in a multi-asset class investment portfolio, 2) the risk and return characteristics of equity markets, 3) the history of CalSTRS' exposure to active and passive management, and 4) peer group comparison regarding active and passive management allocations. The following recommendations were made.

- CalSTRS should continue its commitment to active management within the domestic equity portfolio.
- CalSTRS should commit a material size to active management.
- CalSTRS should adopt an allocation range of 15% to 25% of total domestic equity assets.
- CalSTRS should develop procedures and benchmarks that measure added value and reduce unintended risk exposures or biases.

In October 1997, staff presented and the Investment Committee approved a comprehensive plan on the structure of active management for the domestic equity portfolio. The recommended structure included enhanced indexing and large and small cap stocks using the Russell 3000 index as the benchmark. The Russell 3000 is a broad index that represents both large and small capitalization stocks with a composition strategy that results in the index having varying degrees of value and growth characteristics. A target allocation of 20%, with a range of 15% to 25% was approved.

To implement the structure a Request for Proposal (RFP) was released in February 1998 to hire active managers to provide active portfolio management services. At the time of the release of the RFP, the actual allocation to active management was about 10%, significantly below the approved target of 20%. As a result of the RFP, CalSTRS retained sixteen managers to manage equity portfolios in varying mandates. Funding of these managers began in August 1998 and continued until early 1999.

The following two charts illustrate the progress made in implementing the active management strategy.

Chart 1 – This chart is a depiction of how the portfolio was structured as of December 31, 1997. This structure has little resemblance to the Russell 3000 benchmark.

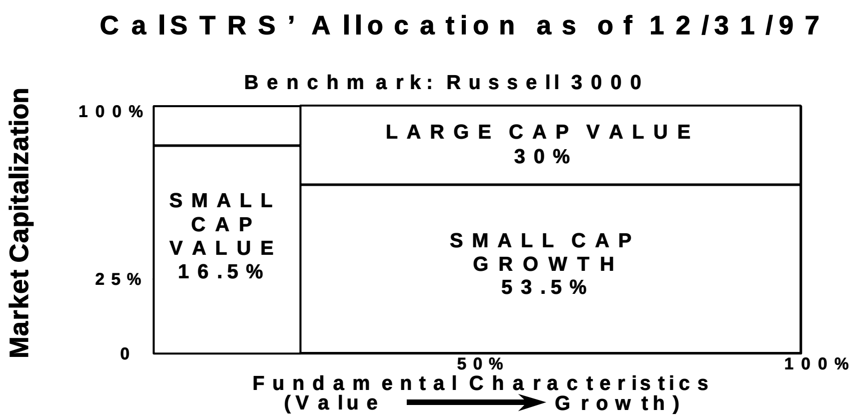
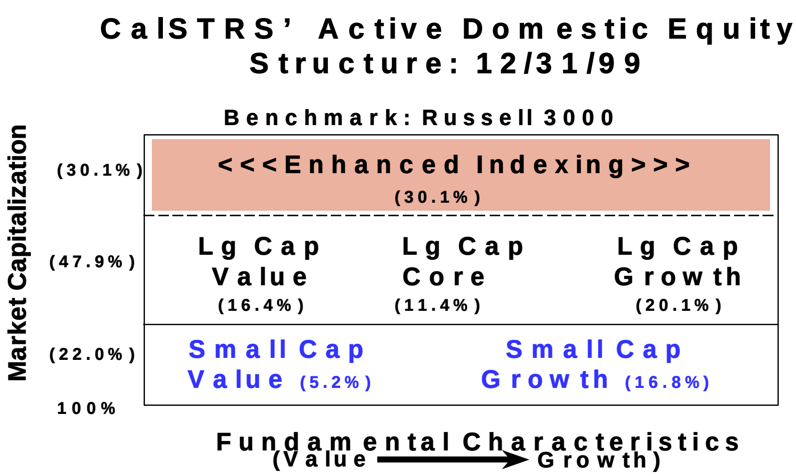
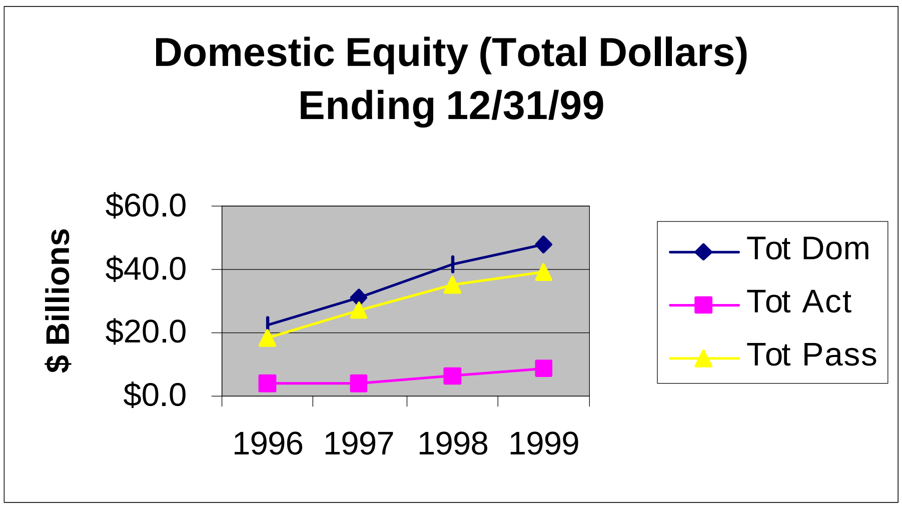


Chart 2 – This chart shows the actual allocations as of December 31, 1999. This chart shows that the structure is now much closer to the benchmark. Deviations from the benchmark are known and intended. There is an overweight to small cap growth stocks and an underweight to small cap value stocks.



The results also show that the active portfolio is well diversified relative to the Russell 3000 Index. Prior to the asset allocation changes discussed in 1997, a significant lack of diversification existed in the active component, as depicted in the December 1997 chart. In this environment, the excess return was severely impaired. For example, there were no portfolios in the large cap growth investment management style. Over the last three years ending 12/31/99, the large cap growth style has achieved a return of 34.1% compared to a return of 22.5% in small cap growth. This figure (large cap growth) only assumes the achievement of the Index Return (Russell 1000 Growth).

Chart 3 – This chart shows the total dollars allocated to CalSTRS' domestic equity portfolio and how this allocation was divided between active and passive management.



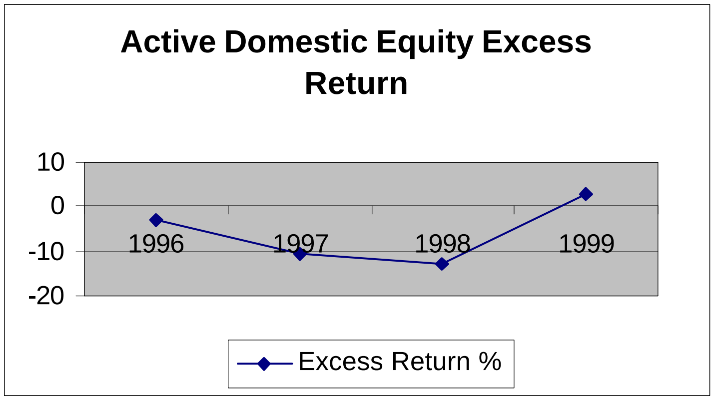
<u>Returns 1996-99:</u>
The table below represents the excess annual return for the active portfolio return versus the Russell 3000 for calendar years 1996-1999:

Table 1

Active Domestic Equity				
Year	Year End Mkt Value $	Annual Return %	Russell 3000 Ret %	Excess Return %
1996	3,610,144,493	18.68	21.82	(3.14)
1997	3,908,070,645	21.05	31.78	(10.73)
1998	6,371,229,935	11.36	24.14	(12.78)
1999	9,018,888,718	23.68	20.90	2.78

Note: The 1998 figures do not represent the fully implemented asset allocation changes; the changes were started in 1998 and fully implemented in 1999.

Chart 4 - The chart below is a graphical representation of the excess return figures presented in the table above.



Conclusion:

The policy change increasing the allocation to active domestic equity management over the last two-year period ending 12/31/99 has resulted in increased value to the portfolio. Over this period, CalSTRS has moved from a passive /active allocation of 90/10% to its stated policy of 80/20%. CalSTRS has implemented the recommendations approved in 1997:

- The commitment to active management has remained.
- The allocation to active management has been increased to make a material contribution to the overall domestic equity portfolio.
- The allocation range is between 15% to 25% of total domestic equity assets.
- Procedures and benchmarks have been developed to measure whether active management adds value compared to the whole market (the passive portfolio) and to reduce unintended risk exposures or biases.

NON-U.S. EQUITY

The first non-U.S. equity investment was incorporated into CalSTRS' portfolio in 1992. The target allocation for non-U.S. was set at 15% of total assets. The structure included both passive and active management and the allocation ranged from a 15/85 passive and active split in 1992 to a 30/70 split in 1997. The passive portfolio is managed to the Morgan Stanley Capital International (MSCI) Europe, Australia, Far East (EAFE) index. The active portion included EAFE and regional (Europe and Pacific Basin) mandates. A passive emerging markets portfolio was added in April 1996. As of December 31, 1997, the active component consisted of seven managers with an EAFE mandate and two managers, with European and Pacific Basin mandates, respectively.

In May 1998 a review was presented to the Investment Committee evaluating the role of active management in non-U.S. equity portfolios. Discussions included a review of the mandates to be utilized to structure the non-U.S. equity portfolio and the appropriate allocation to active management. The following recommendations were made and approved by the Investment Committee:

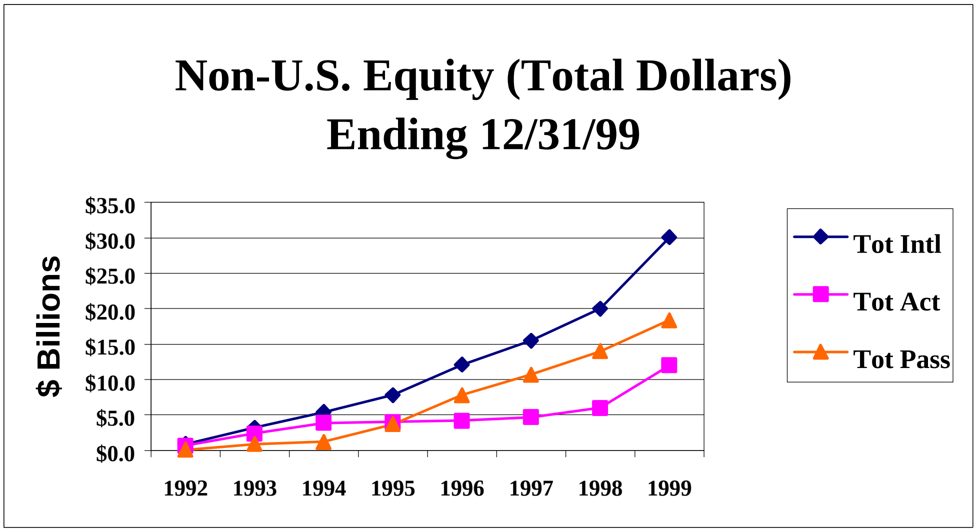
- The MSCI EAFE Index should continue to be the benchmark for CalSTRS' non-U.S. equity portfolio. **Note:** In November 1998 the benchmark was changed to the MSCI All Country World Index ex-U.S. Regional indices would be used for regional mandates.

- Modify the strategic passive/active allocation target to 50/50 with a range of 45% to 55%. Increasing active management in the non-U.S. equity portfolio will enhance the total portfolio's risk and return profile.

- The actively managed allocation should consist of EAFE and regional (European and Pacific Basin) mandates. The strategic allocation target for the regional mandates should be the EAFE weightings with a range of +/- 5% for each region.

Similar to the domestic implementation, a Request for Proposal was released to implement the non-U.S. equity structure. As a result of this process, 10 incumbent managers were rehired with 9 additional managers selected, bringing the total of non-U.S. equity managers to 19. Funding of these managers began in June 1999 and will soon be completed.

Chart 1, below shows the total dollars allocated to CalSTRS' non-US equity portfolio and how this allocation was divided between active and passive management.



The Chart above illustrates that since 1992, non-U.S. investments have steadily increased towards $30 billion. During this same period, total passive non-U.S. increased to $18.4 billion, while total active non-U.S. has increased to $12.0 billion.

In 1993, the active/passive allocation of the non- U.S. equity portfolio, was 70% to active and 30% to passive management. By the end of 1997, these allocations were reversed, with an allocation of 30% to active management and 70% to passive management. By December 31, 1999, the allocation to active management was 40% and passive management was 60%, bringing CalSTRS' non-U.S. structure closer to the target of a 50/50 split. See chart 2 below.

Chart 2

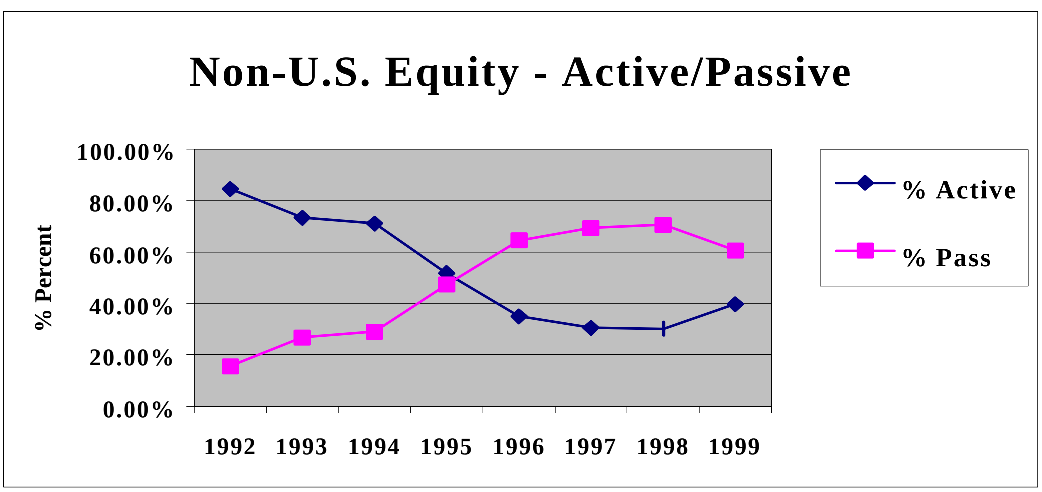
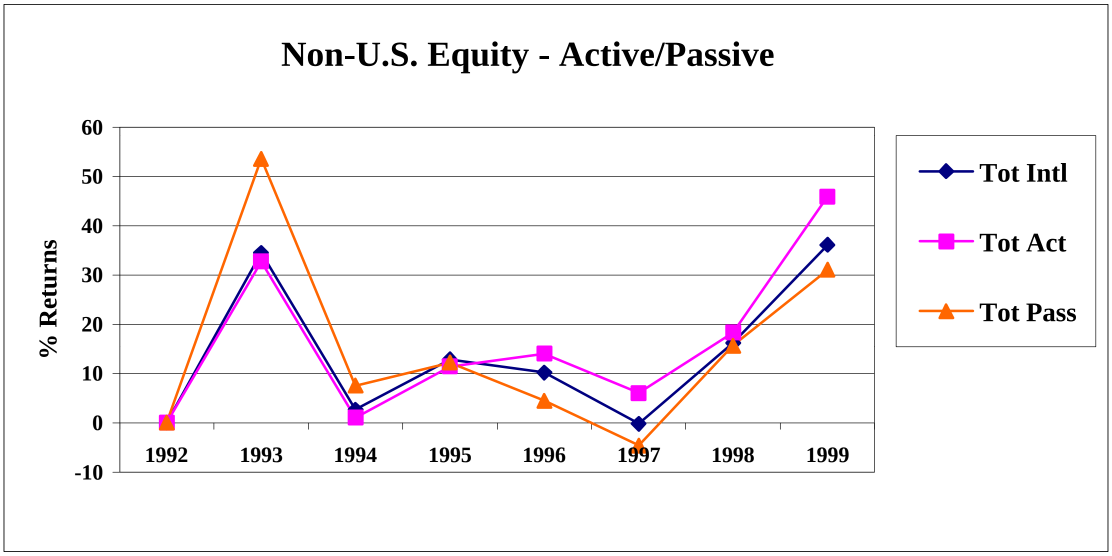


Chart 3 – This chart shows the total, active and passive returns for the non-U.S. portfolio from 1992 through 1999.



Returns 1996-1999

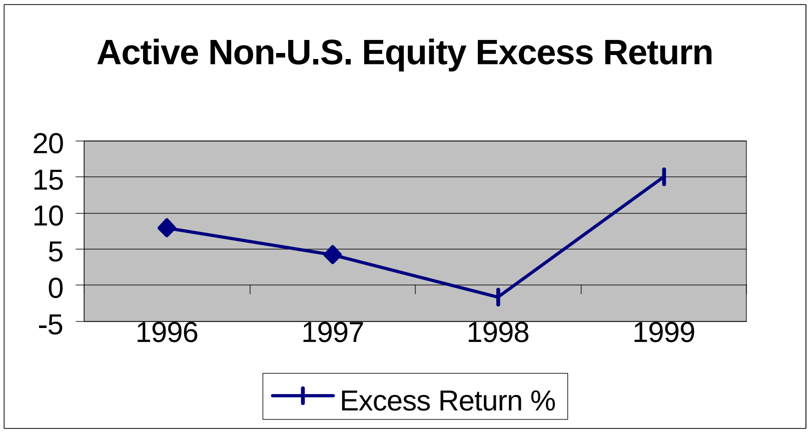
The table below represents the total excess returns from active management versus the benchmark for calendar year 1996-1999.

Table 1

Active Non-US Equity				
Year	Year End Mkt Value $	Annual Return %	Benchmark Return %	Excess Return %
1996	4,234,085,970	14.00	6.05	7.95
1997	4,719,970,646	6.03	1.78	4.25
1998	5,978,865,387	18.34	20.00	(1.66)
1999	12,020,849,322	45.91	30.90	15.01

Chart 4 below, is a graphical representation of the excess return figures presented in the table above.

Chart 4



Conclusion

The increased allocation to active non-U.S. equity management has resulted in additional value to the portfolio. Increasing active management in the non-U.S. equity portfolio has enhanced the total portfolio's risk and return profile. Over the last four years, the portfolio has steadily moved towards the target 50/50 split between active and passive in the non-U.S. portfolio. CalSTRS has developed procedures and benchmarks that accurately measure added value from active management and reduces unintended risk exposures or biases in the non-U.S. portfolio.